3 1761 07488431 3

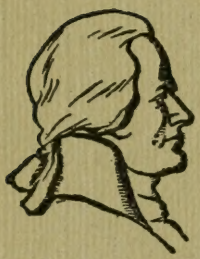
EcC
M6896

EcC
M6896

[Modern business talks]

HOLDING THE WATCH ON YOUR INVESTMENTS

If one-half of investment success consists in knowing what to buy, the other half consists in knowing when to buy.



MODERN BUSINESS
TALK No. 46
(WITH VOLUME 23)

ALEXANDER HAMILTON INSTITUTE
NEW YORK

Holding the Watch on Your Investments

This Talk, to be read in connection with Volume 23, forms part of READING ASSIGNMENT 46

15
2 32 895
1. 6. 29.

ALEXANDER HAMILTON INSTITUTE
NEW YORK

Copyright, 1918 by Alexander Hamilton Institute
Copyrighted in Great Britain in 1918
All Rights Reserved

READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Chapter XI to the end of Volume 23, "Investment", and (3) Problem No. 23.

Of the four elements of success, the time, the place, the man and the occasion, none can be neglected. In investment, success depends in large measure on the time the investment is made. The present Reading Assignment, dealing largely with the cycle of trade, emphasizes this point, but it also suggests that no study of business in any of its manifestations is complete without a knowledge of the ebb and flow of prosperity which marks our business life.

Holding the Watch on Your Investments

> The security market is the most perfect organization extant for discounting the effect of expected future events.—Page 239, Chapter XV, Volume 23 of the MODERN BUSINESS Text.

The Institute has an active interchange of views and experiences with its subscribers. Many of them visit its headquarters and we feel under obligation to them for the help they give us. In one form or another we are continually passing it on to other subscribers, thus realizing cooperative ideals.

A visitor the other day unburdened his soul to us on the subject of investments. What he told us was so pertinent to the present reading assignment that we are giving it to you, substantially in his words.

THE SUBSCRIBER'S STORY

Some men in our town were talking recently about investments and perhaps what they said will interest you. Of course I may not repeat their conversation with the fidelity of a dictagraph, but I can reproduce its substance. Part of it I overheard, and part of it I have pieced together from what one of the men told me afterward. Just at that time I was reading the Text on "Investment" and perhaps that is the reason I remember it in such detail.

There were three of them in the bunch and they are all located out at the north end of the city. Tarrant is with his father in a shoe manufacturing business. Elton owns a small knitting mill. Kilbourne came to town a year or so ago as sales manager of the chocolate mill. They used to lunch regularly at the club. Tarrant generally took them down and back in his car.

Kilbourne is the youngest of the crowd, but he is easily the keenest and best informed. I used to think it was pathetic the way Tarrant and Elton almost hung on his words and sought his opinion on this and that, and even brought their business problems to him. I couldn't help hearing a lot of it from day to day and I didn't know what to think of those two. It didn't look bright.

Leading Him On

This particular day at luncheon, as usual, Tarrant started in with the coffee. I was seated not half a dozen feet away.

"Kilbourne", he said, "my broker says he has a good thing for me in an investment way. It's a preferred stock. He told me all about it. It looks like a good proposition and I have a little idle money, but I am not sure that this is the right time to invest. So I told him that I would look into the matter."

"Have you done so?" asked Kilbourne.

"That's what I'm doing now", said Tarrant, in his serious way. "I'm putting it up to you. I have an idea that you are one of those wise ones who can

figure out a bond yield to the fifth decimal place and tell to a split second the time to buy."

That was spreading it on pretty thick, so thick it made me fidget in my chair. Even Kilbourne looked up sharply. But Tarrant was serious. So Kilbourne cracked a smile and waved his hand deprecatingly.

"I'm willing to admit, tho, for your private ears", he said, "that I don't get stung very often."

"How do you do it?" said Elton. "I dropped six hundred dollars once in bonds."

"How did *you* do it?" returned Kilbourne, in amazement.

"Oh, I did it all right", Elton answered. "You haven't any idea of my ability! They told me bonds were safe—in comparison with stocks—and that I couldn't lose money. I went right out and proved I could."

"They must have been worthless, then."

"On the contrary, they were good solid securities."

"All right", said Kilbourne, "I'll bite. You tell me how."

"Why, I just bought and sold at the wrong time, that's all", said Elton. "You'll say I waited too long to buy and then sold too soon. I know that—now. What I want to find out is how I could have known it beforehand."

How to Lose on Anything

"Why, Elton", said Kilbourne, "you don't want me to tell you that you can lose money on anything

by the simple little expedient of buying high and selling low. What do you do when you buy yarn or thread for the mill?"

"Yes, yes", returned Elton, "but that isn't the same as the security market, is it? Conditions there are too intricate. I knew I wasn't a good student and I know now I must be a bad guesser."

"Tarrant could have told you", suggested Kilbourne. "He's a bloated bondholder."

"Well, I don't know", replied Tarrant. "I have some bonds. I try to buy intelligently. But I confess I haven't paid as much attention to market conditions as I know I ought. I buy when I have the money and more for safety's sake than for profit by fractions. Yes, I suppose on the whole I find the market a little intricate and the reports often confusing."

"Haven't you ever run across any such thing as a 'market barometer' ", asked Kilbourne, "which gives you all the information you need, and doesn't take more than a minute a day to follow?"

"What barometers?" demanded Elton.

"Well, take the discount rate on commercial paper, for instance", said Kilbourne, "or the amount of the unfilled orders of the United States Steel Corporation, or the money rates."

"All Greek to me", protested Elton, and Tarrant looked doubtful.

"Well, you surprise me, you two", said Kilbourne. "You're not 'spoofing' me, I hope." He leaned back in his chair and looked at his watch. "I ought to

warn you", he remarked, grinning, "that this is my hobby."

"Go to it!" cried the others.

I edged my chair a trifle nearer. There was nothing private about the subject and, as I said, I had just reached it in my study.

What the Price of a Security Depends On

"All right", said Kilbourne. "On your heads be it! Now let's see. First, a little kindergarten stuff. The price of a security has to depend, doesn't it, on the conditions inside the issuing company and the trade, and the conditions outside them? There isn't anything else for it to depend on. Well, the inside elements are, of course, the value of the company property, its financial conditions, earnings, character of management, the demand for its goods or services, the security of its sources of supply, the amount of competition and other like things. All right. Then the outside factors are the general business conditions, the conditions in all other companies and trades. These cover many different things, but for all practical purposes they can be summed up as three: volume of business, volume of money and volume of credit."

"Ah, a little theory", remarked Elton, with a knowing look.

"A little analysis", corrected Kilbourne, "and pretty vital, too, you'll say in a minute. Now, the factors vary in importance. Sometimes the inside ones seem strongest—they actually are with a strong

company—but sometimes the outside ones just dominate things for a while. For instance, the property and earnings of a company will be as good at one time as another; everything about it will be exactly the same, and yet its securities will move up or down when there is a fundamental change in business conditions, just as all other securities do. Strong internal conditions will modify the change, but they will not prevent it.

"Now, you ask me what makes these fundamental changes and how they can be foreseen and discounted. Did either of you ever know that this periodical alternation of good and bad times came in with the development of banking, investment and credit? I didn't until I read about it recently. It explains things. For instance, so long as men had to save their own capital, business could grow only as savings grew. There were no commercial banks then. Merchants and manufacturers got no credit and gave none. Business was on a strictly cash basis. And therefore bad times came only from war, drought, pestilence and like disasters."

"Only!" remarked Elton.

But When Some Saved and Others Spent

"But", said Kilbourne, ignoring the interruption, "when some men saved and others borrowed, and a third class stood between, receiving the savings on deposit and loaning them out, there arose a new condition. That was the significant thing about it, that

it was one of specialization, and this specialization, this division into classes of savers and enterprisers or business men, is what has started the tremendous modern expansion in business. That's an interesting thing to know, isn't it? So far so good. But there was a fly in the ointment—a contingent liability went with the expansion. It was all right so long as the different specializing parts kept in touch and men exercised the same care, foresight and integrity that they did when each saved his capital and invested it in his own business.

"But the danger in specializing is that specialists may draw apart—may not act as a unit for the good of all. It is difficult for men who 'invest' their money elsewhere to know as much about the other business as they would about their own. Also, in the beginning bankers were not so careful and conscientious in handling the money deposited with them as they would have been in handling their own savings. And it's a sure thing that more people borrow than ever pay back again. So that was the beginning of the danger. It wasn't very great at first because the expansion of business wasn't very great.

"Next the credit idea developed. That, too, was a big thing. It gave tremendous additional opportunities for business expansion, but as before they were accompanied by the same old opportunities for abuse, immensely multiplied.

"Credit", continued Kilbourne, "is a fine thing if it is used as it ought to be used. But a good many people have the same notion of it that a certain fa-

mous but impecunious English poet had. Whenever pressed to settle a debt, he would dash off a promissory note, adding with a sigh of relief, 'Thank heaven, there's another bill paid.' "

"I know a few like that", said Elton, "and they're not poets, either!"

"It took the people a long time to learn", Kilbourne went on, "that prosperity built up on excessive credit isn't sound. There were panics. They came periodically. It's over a hundred years since they started. People pretty soon saw the immediate cause, that it was overtrading and speculation, but hardly anybody laid the trouble to too much credit. At any rate, if anybody did, nobody paid any attention to him. Prosperity and depression went on alternating as before.

Discovered a Cycle of Trade

"But by the time there had been a dozen or so of experiences of the sort, everybody who did any thinking began to demand an explanation. The thing was carefully studied and by and by the economists demonstrated what they called a 'cycle of trade.' But you know this? It's old stuff!"

"Not as you tell it", said Tarrant.

"Go on", said Elton.

"The cycle starts, then, say", continued Kilbourne, "with a normal period, which is one of improvement and expansion just beginning. The banks are full of money. This is because during the previous period of depression people feared to invest their savings and

business men confined their loans to the smallest necessary amounts.

"After a time the rate of interest stops falling; the price of stocks, too; they persist at a low point. This is the signal that big business has been long awaiting. Certain now that a turn for the better is at hand, the railroads and other large industries, the biggest and most intelligent borrowers, come into the market for funds. They need them to make the necessary repairs, renewals and extensions that were deferred when business was falling off. They offer their bonds. Now since investors cannot afford to let their money lie idle indefinitely, and are only waiting for something safe and sound, the bonds find ready purchasers. Bonds, as you know, sell better in bad times than stocks do because the bond yield is certain, whereas stock dividends may go off or cease altogether. So standard railroad bonds will draw a relatively low interest and yet sell high, which is of course what the railroad borrowers want.

Money at Work Makes Wheels Go Round

"The successful borrowing of the railroads and the large industrial interests becomes an example to other corporations and also to the investing class. Meanwhile, the money raised by bond sales is being spent. It is going into circulation. It increases the demand for all sorts of goods—your knitted goods, Tarrant's boots and shoes, our chocolate. Merchants enlarge their stocks, we manufacturers buy more raw ma-

terial, hire more help, borrow more money at the bank or else sell bonds to enlarge our plants.

"All this", continued Kilbourne, "makes the wheels go faster. Soon everybody in town and elsewhere is employed and buying. Still the banks have money to loan and credit goes on expanding. Industrial enterprise keeps up with it. Stocks go up. Prosperity is general. Great fortunes are made.

"That's all right. Now we begin to see the other side. The signs of wealth on every hand begin to dazzle and excite the people. They are seized with a desire for luxury and pleasure. As the phrase goes, they 'want theirs.' When that stage is reached, caution is thrown to the winds. Manufacturers, expecting trade to keep on growing, commit themselves heavily and extend their business on bank credit. Not all do, but a good many. The credit coming easily, they pass it along to their customers, the merchants. These in turn enlarge their stores, their stocks of merchandise, their credits. And the bankers straining their resources to accommodate all, have to keep it up right to the very last safe minute.

"And the people—why, by this time what's a mere 5 or 6 per cent in interest or dividends! Nothing! Aren't there gold and copper mines which actually 'guarantee' 25, 50 per cent and more? Aren't fortunes being made out of industrial consolidations? Why not get in on some of it? So Wall Street is crowded. Speculation flourishes. And it's helped along—I am speaking now of conditions before the new Federal Reserve Act—by the piling up of funds

in New York. Promoters of 'wild cat' and 'blue sky' ventures are working overtime to supply the demand for good gambles. People act as if they think it will last forever, or at least until they can cash in on their speculations and get out.

The End in Sight

"Meanwhile the plot is thickening. Things are speeding up. Many people begin to find the pace hard to sustain. They realize now that they can't go on buying indefinitely. They have bought too much already on credit and must pay up. Or else they have spent too much of their salaries or wages and must economize. So the demand for merchandise begins to slacken. Business, being overextended, finds it harder to meet its obligations. The banks begin to tighten up on accommodation and eventually to call loans. Money rates creep up and check speculation.

"For some time before this, I ought to say, stock prices have been falling. The insiders or rather the intelligent observers are selling out in anticipation of the inevitable end. The business strain grows, failures increase. By and by the country wakes up and sees the danger, but there is no heading it off then. It is too late. Fear only intensifies and hastens the smash. Suddenly it comes in the shape of a big failure, perhaps a big bank or financial house, then two or three more big ones. Then there is a grand scramble for cash, and the panic is on, full blast.

"After the worst is over, there is a long period of depression. This is due to general liquidation and economizing, a sort of shaking down and weeding out of wastes and inefficiencies, which are necessary before anybody will have much confidence again.

"Meantime business is going on, because people have to live and there is always some demand to be satisfied. The panic has only shorn off the plush—the basic fabric is there untouched. And after a time recovery sets in, as I first described, and the whole thing starts over."

"So that's the cycle", said Elton.

Panics First Every Ten Years, Then Every Five

"That's the cycle", said Kilbourne. "It used to cover about ten years. Prosperity lasted from five to seven years, panic from a few months to a few years and liquidation a few years. During the thirty years prior to the outbreak of the war, however, the cycle was shortened to from three to six years. Or, to put it another way, we were having junior panics among the main crises."

"Why is that?" asked Tarrant. "I have often wondered."

"Increase in business ability and industrial capacity, I suppose", answered Kilbourne, "with no corresponding check on overbanking and overtrading. Business learned how to pick itself up quickly, but it didn't learn how to keep from falling down."

"And of course if we understand the cycle we can protect ourselves and take advantage of conditions", said Tarrant.

A Safe Rule for Buying and Selling

"Well, why not?" replied Kilbourne. "You will buy your stocks at the tail of the bad times, when earning capacity is at the lowest and any change must be for the better; and buy your bonds at the very top of prosperity, when stocks are high and thoughtless investors are dreaming of big stock dividends and despising the little bond yields. In other words, to be safe, adopt the old rule: 'Buy during the last of a selling movement and sell during the last of a buying movement.' That is just the reverse of what the crowd does. You followed the crowd, Elton, and you paid for the experience."

"But I have read that there aren't going to be any more panics now that the Federal Reserve System has been established", said Tarrant.

"That's probably true", answered Kilbourne. "The new Federal Reserve System does discourage overtrading. It can check borrowing for speculation by raising the rediscount rate and thus forcing the banks to raise their discount rate. It is taking some of the danger out of credit by influencing business men to change from open book accounts to acceptances. It gives the banks superior accommodations on the acceptances and the banks create a demand for them. Lastly, the system is organizing the banks

and mobilizing the banking resources of the country. That means that funds no longer accumulate in New York City to be soaked up by Wall Street, but instead flow here and there, wherever needed for commercial purposes.

"I don't see for my own part how the old sharp alternations of 'good' and 'bad' times can come back to plague us. We won't really know about it until the war ends and conditions are more normal. But that doesn't mean that there won't be any ups and downs in securities and prices. We'd first have to remove all the elements of doubt, educate everybody in business principles and reform human nature. Certainly, securities will go up and down in some degree and good judgment will have the same chance to make a profit."

"And pig iron and the rest are barometers, you said", remarked Elton.

A Few Business Barometers

"What I meant was this", said Kilbourne. "Instead of trying to keep our eyes on every part of the industrial field and financial market we may pick out a few typical tendencies for guides. For instance, the amount of unfilled orders of the United States Steel Corporation and the price of commercial paper are just as good for this purpose as the combined statistics of a hundred other factors, because they cover business conditions and reflect all the important changes in business. Steel is consumed in the con-

struction of railroads and transportation equipment, office buildings, apartment houses, farm implements, factories, machineries, and all branches of industry. The price of commercial paper is fixed by the demand and supply both of paper and money. To add pig iron prices, stock and bond prices, the rates of interest, and so forth, will increase your knowledge and confidence, but will not give you any surer guidance. As your old friend Solomon said, 'There's a time to weep and a time to laugh.' He might just as well have said, 'There's a time to buy and a time to sell.' After you know the ropes it will be all laughing and no weeping."

"I see", said Elton, and he added emphatically, "It's the first time I ever did see. I have never been much of a student—never thought I had the time—and I've passed up a lot of things in the newspapers that I now see mean something. I wouldn't have missed this talk for a thousand dollars. It was worth losing that much on the bonds to find out exactly why I lost."

Money Goes Where Brains Are

Then he looked across significantly at Tarrant. Tarrant nodded and Elton continued in a lower voice but not so low but that I got the drift:

"Kilbourne, I have just patented a knitting machine that promises big things. I have taken enough orders to keep a much larger factory going for a couple of years. I have some money and Tarrant can raise all the additional backing that's needed.

I'm going to be the ornamental president and practical factory man, but we need a general manager, and Tarrant and I have decided that it's up to you. We like the way you talk, your ideas and all that, and we're prepared to do the right thing by you in every way."

The offer took Kilbourne by surprise. I happen to know that he had never sized up either of the two men as "comers." But you can never tell. They had had their eye on him from the first and all the time I was pitying them for their simplicity, they were drawing him out. It was not, of course, his knowledge of investments that made him valuable to them. I presume they only wanted to see just how far his knowledge of business went. When they found he knew as much about corporation finance as he did about sales, and had gone as deeply into investment as he had into real estate and accounting and credits, why naturally they didn't think any the less of his experience and his judgment.

Probably they made no mistake in looking at it that way. They've only just spread out now. Kilbourne didn't snap at the chance. He held them off while he investigated and then a little longer while he turned their plans inside out and reorganized the company on a scale which gives him a bigger slice of the stock than he could have had on any other basis.

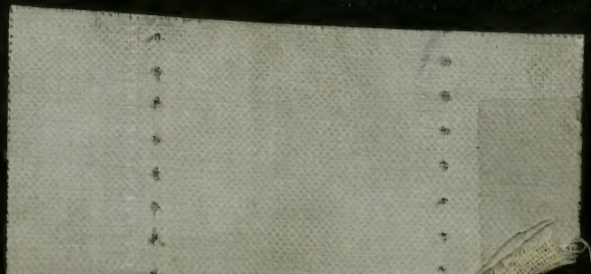
Anybody Can Learn How

All this set me thinking more than a little on the subject of timeliness. There is a time to buy securi-

ties and a time to sell them, a time to stay in the market and a time to keep out. I haven't taken Kilbourne's word alone for it. I've looked it up in the Text and I know it's so. I hope to make good use of that in keeping out of trouble and turning my savings to the best account.

But it comes home to me that one of the very best fruits of a knowledge of investment principles is that it supplements and complements all your other business knowledge and makes you a man of all 'round business experience and judgment. You're never quite sound so long as there is a single important department of business that you're not up in. You never know who's watching you and totting up your strong and weak points. You've got to be ready. There's a time to know, yes—but it's all the time.

NO
26



UTL AT DOWNSVIEW
D RANGE BAY SHLF POS ITEM C
39 11 11 04 13 012 5